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PROTECTING THE PEACE WHILE PROFITING THE POOR: MICROFINANCE AND TERRORIST FINANCING REGULATION

*Darren Keyes**

I. INTRODUCTION

DURING the 1960s, organizations began offering very small loans to the world's poorest people. Because the loans were so small, such services were dubbed microfinance. Over the years, microfinance services expanded to include savings, insurance, and remittance services. Additionally, many of the early participants in the industry were social and religious nonprofit organizations motivated as much by faith and charity as by economics. In recent years, as the microfinance industry has matured, commercial banks and equity investors have awakened to the potential of an untapped market of 3 billion customers. Many banks enter the industry by providing capital to nonprofit microfinance organizations, while other entities directly provide an array of financial services to the world's poorest populations. Financial institutions have realized that investing in the poor is a profitable proposition. But following September 11, 2001, most of the players in the microfinance industry must confront the challenge of complying with new anti-money laundering and combating the financing of terrorism (AML/CFT) regulations.

By encouraging microfinance expansion and implementing AML/CFT regulations, nations committed to stopping terrorism will protect the peace while profiting the poor. This paper examines the issues arising from the intersection of an evolving microfinance industry with new financial regulatory regimes containing AML/CFT regulations. The remainder of Part I briefly outlines the problem of terrorist financing, the microfinance industry, and the intersection of both. Part II provides an overview of the microfinance industry in Latin America including: legal forms of entities, services offered, financing methods, and relevant regu-

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lation in Bolivia, Mexico, and Colombia. Part III summarizes international legal developments regarding the financial services regulation designed to prevent the financing of terrorism. Part IV evaluates proposed alternatives for balancing the needs of the poor against the need to curtail terrorist financing.

A. THE PROBLEM: TERRORIST FINANCING AND MONEY LAUNDERING

Money laundering and terrorist financing pose a serious threat to the soundness of the international financial system. Combating these threats requires a coordinated and cooperative response from the international community at large.¹

Money laundering disguises “the illegal origin of criminal proceeds without disclosing their source,” while terrorist financing “uses legitimate or illegitimate funds to facilitate an act of terror.”² After the September 11, 2001, attacks, the international community mobilized to combat terrorism. Article 2 of the United Nations International Convention for the Suppression of the Financing of Terrorism defines terrorism as:

[a]ny . . . act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act.³

As part of the strategy to defeat terrorists, the international community focused on pursuing various strategies to combat terrorist financing. Yet using money for illegal and illicit purposes is not a novel concept. In fact, about US \$1 trillion are laundered annually.⁴ Estimates suggest that money laundering could amount to as much as 2 to 5 percent of world gross domestic product.⁵ Unfortunately, knowing how much laundered money finances terrorism cannot be accurately calculated. While putting a dent in a trillion dollar problem may seem like an easy undertaking, the most significant and tragic terrorist attacks have cost a mere fraction of these enormous amounts. For example, the FBI estimated the September

1. Kader Asmal, President, Fin. Action Task Force on Money Laundering, An Address for the Plenary VIII Meeting of the Asia Pacific Group (July 11, 2005), <http://www.fatf-gafi.org/dataoecd/13/55/35264257.pdf>.
2. JENNIFER ISERN ET AL., FOCUS NOTE NO. 29: AML/CFT REGULATION: IMPLICATIONS FOR FINANCIAL SERVICE PROVIDERS THAT SERVE LOW-INCOME PEOPLE 3 (2005), available at http://www.microfinancegateway.org/files/27418_file_Focus_Note_29.pdf [hereinafter AML/CFT IMPLICATIONS].
3. International Convention for the Suppression of the Financing of Terrorism, art. 2, para. 1(b), 39 U.N. Doc. A/RES/54/109 (Dec. 9, 1999), available at <http://untreaty.un.org/English/Terrorism/Conv12.pdf>.
4. World Bank Group, *Anti-Money Laundering and Combating the Financing of Terrorism*, <http://www1.worldbank.org/finance/html/amlcft/index.htm> (last visited Feb. 6, 2006).
5. International Monetary Fund, *Fighting Dirty Money*, 33 IMF SURVEY 242 (2004), available at <http://www.imf.org/external/pubs/ft/survey/2004/080904.pdf> [hereinafter IMF SURVEY].

11th attacks cost between \$300,000 and \$500,000,⁶ and the terrorist attack in 2000 on the U.S.S. Cole cost only \$50,000.⁷ Looking for miniscule amounts like these in a US \$1 trillion money laundering industry is like looking for a needle in a haystack.

Since September 11, 2001, increased regulation has worked to help prevent terrorists from exploiting the global financial system. As one U.S. government official declared, “[t]errorists can no longer safely use the international banking system.”⁸ As a result, terrorists are turning to alternative methods to launder funds including cash couriers, charitable organizations, and informal value transfer systems.⁹ While these alternative methods supply an important need in the developing world, the microfinance industry provides similar services that are not as vulnerable to terrorist exploitation.

B. THE INDUSTRY: MICROFINANCE

Historically, microfinance has been synonymous with microcredit—the provision of very small, short term loans to poor entrepreneurs in developing countries.¹⁰ Microcredit is in high demand in developing countries where local moneylenders charge as much as 10 to 20 percent interest per day—the equivalent of an annual percentage rate of 4000 percent!¹¹ Although microcredit typically carries higher interest rates than banking industry norms, higher rates are necessary to cover the increased costs¹² of serving the microfinance market segment. And these higher interest rates still compare very favorably to the exorbitant rates charged by moneylenders. In recent years, microfinance services have expanded to include the offering of credit, savings, remittance, and insurance services to the world’s poorest clientele.¹³ Microfinance institutions (MFIs) special-

6. Matthew A. Levitt, *The Political Economy of Middle East Terrorism*, 6 MIDDLE EAST REV. OF INT’L AFF. 49 (2002), available at <http://meria.idc.ac.il/journal/2002/issue4/levitt.pdf>.

7. *Al-Qaeda Operations Are Rather Cheap*, THE ECONOMIST, Oct. 4, 2003.

8. Todd M. Hinnen, *The Cyber-Front in the War on Terrorism: Curbing Terrorist Use of the Internet*, 5 COLUM. SCI. & TECH. L. REV. 5, 3 (2003/2004), <http://www.stlr.org/html/volume5/hinnen.pdf> (quoting Honorable Alan Larson, Under Sec’y of State for Econ., Bus., and Agric. Affairs).

9. See generally Financial Action Task Force [FATF], *Methods and Trends*, http://www.fatf-gafi.org/document/23/0,2340,en_32250379_32237277_34037591_1_1_1_1,00.html (last visited Nov. 7, 2006).

10. AML/CFT IMPLICATIONS, *supra* note 2, at 11.

11. CONSULTATIVE GROUP TO ASSIST THE POOR, MICROFINANCE IN CENTRAL AMERICA AND MEXICO: PROFILE AND CHALLENGES 3 (2001), available at http://www.cgap.org/docs/CaseStudy_centralamerica.pdf [hereinafter CGAP CASE STUDY].

12. Increased costs result from managing thousands of small loans with a high turnover rate and conducting extensive client visits sometimes in remote locations. TOR JANSSON ET AL., PRINCIPLES AND PRACTICES FOR REGULATING AND SUPERVISING MICROFINANCE 23 (2004), available at http://www.microfinancegateway.org/files/21298_30.pdf [hereinafter PRINCIPLES AND PRACTICES].

13. INTERNATIONAL MONETARY FUND, MICROFINANCE: A VIEW FROM THE FUND 4 (2005), available at <http://www.imf.org/External/np/pp/eng/2005/012505.pdf> [hereinafter IMF MICROFINANCE].

ize in providing these financial services, and throughout this paper the term refers generally to entities that participate in the microfinance industry.

Demand for microfinance services is huge. About 3 billion people subsist on only \$2 per day, while 1 billion of these live on only \$1 or less per day.¹⁴ The United Nations Capital Development Fund (UNCDF) estimates the total microfinance market to be between 400 and 500 million households—with only around 30 million, or less than 10 percent, reported to have access to microfinance services in 2002.¹⁵ Studies indicate that the fruits of microfinance include increased “income stability and growth, school attendance, nutrition, and health” and the empowerment of women.¹⁶ Yet in 2001, the World Bank (Bank) estimated that the 10,000 existing MFIs only reached 4 percent of the potential market.¹⁷ Perhaps this is due in part to the fact that microfinance clients typically lack basic financial information and “have difficulty obtaining legal documents verifying their business activity, land tenure, value of assets and even identity.”¹⁸

Modern microfinance began during the late 1960s, but only in the past two decades has the industry matured and demonstrated that microfinance is a sustainable, even profitable, operational model. In October 2005, United Nations’ Secretary-General Kofi Annan stated, “[m]icrofinance is not charity. In some cases, it might have *started* out as philanthropy. But today it is a real business.”¹⁹ Policymakers and business people have realized that investing in the poor is a profitable proposition. As the International Monetary Fund (IMF) reports:

To achieve its full potential, microfinance must become a fully integrated part of a developing country’s mainstream financial system

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14. World Bank, *About Us: Millennium Development Goals*, <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,,contentMDK:20104132~menuPK:250991~pagePK:43912~piPK:44037~theSitePK:29708,00.html> (last visited Feb. 25, 2006).
 15. United Nations Capital Development Fund, *Basic Facts About Microfinance*, <http://www.uncdf.org/english/microfinance/facts.php> (last visited Feb. 6, 2006) [hereinafter *Basic Facts*].
 16. Elizabeth Littlefield & Richard Rosenberg, *Microfinance and the Poor*, FIN. & DEV., June 2004, at 38, 39, available at <http://www.imf.org/external/pubs/ft/fandd/2004/06/pdf/littlefi.pdf>.
 17. *Basic Facts*, *supra* note 15.
 18. JACQUES TRIGO LOUBIÈRE ET AL., SUPERVISING & REGULATING MICROFINANCE IN THE CONTEXT OF FINANCIAL SECTOR LIBERALIZATION: LESSONS FROM BOLIVIA, COLOMBIA AND MEXICO 38 (2004), available at http://www.microfinancegateway.org/files/21469_M13e.pdf [hereinafter SUPERVISING & REGULATING MICROFINANCE].
 19. Ximena Escobar de Nogales, *Geneva Symposium Addresses Investing Private Capital in Microfinance: Attracts Broad Private Sector Participation*, MICROFINANCE MATTERS, Oct. 2005, at 33, available at http://uncdf.org/english/microfinance/newsletter/pages/2005_10/Microfinance_Matters_Issue_17.pdf. United Nations Secretary-General Kofi Annan spoke these words as he opened the two-day Geneva Private Capital Symposium that was held from October 10-11, 2005, and focused on the business case for private capital in microfinance from the perspective of financial and banking experts. *Id.*

rather than being confined to a niche of the development community.

... There is growing awareness that building financial systems for the poor means building sound domestic financial intermediaries that can mobilize and recycle domestic savings. Foreign donor and social investor capital diminishes as individual institutions and entire markets mature.²⁰

In the early years of microfinance, foreign donor funds were critical to establishing the industry. Substantial support came from the United Nations Development Program (UNDP) and the United States Agency for International Development (USAID), as well as regional development banks including the Inter-American Development Bank (IDB).²¹ The United States, one of the leading supporters of microfinance, "has committed more than \$2 billion . . . in the past 15 years, averaging \$155 million annually across almost 50 countries."²² While these foreign donor funds were important to the industry's incubation, "depositors, creditors and investors . . . are the ones that in the long run will provide the funds to sustain the growth of the microfinance industry."²³

C. THE INTERSECTION: MICROFINANCE AND TERRORIST FINANCING

So terrorist financing is a prevalent problem, and microfinance is a rapidly growing industry. But what is the point? Both of these movements are now intersecting at a perplexing crossroads. After September 11, 2001, AML/CFT regulatory regimes became more stringent and pervasive.²⁴ At the same time, microfinance industry growth has been accelerating and expanding to obtain a formidable share of the international financial services market. Now, governments, regulators, MFIs, bankers, development specialists, and multitudes of potential microfinance customers are wondering how to reconcile the goals and objectives of the microfinance industry with the implementation of international AML/CFT regulations.²⁵

Two primary concerns are remittances and the participation of non-governmental organizations (NGOs) in the microfinance industry. Remittance services remain vulnerable to exploitation by terrorists, and NGOs are considered to be potential conduits of terror funds.²⁶ These

20. Littlefield & Rosenberg, *supra* note 16, at 39.

21. IMF MICROFINANCE, *supra* note 13, at 18.

22. Isobel Coleman, *Defending Microfinance*, 29 FLETCHER F. WORLD AFF. 181, 182 (2005).

23. PRINCIPLES AND PRACTICES, *supra* note 12, at 16.

24. Posting of David Porteous to Affordable Housing Institute Blog: The Bankable Frontier, http://www.affordablehousinginstitute.org/blogs/bankable/2005/09/money_launderin.html (Sept. 10, 2005) [hereinafter Porteous].

25. As the President of the Financial Action Task Force stated, "[y]et another area of interest is the application of AML/CFT standards to microfinance." Asmal, *supra* note 1, at 11.

26. Porteous, *supra* note 24.

two concerns are a part of the larger dilemma. Developing nations that do not implement sufficient AML/CFT regimes risk being “frozen out of the international financial system,” because bank regulators in developed countries will increasingly “discourage their institutions from conducting financial transactions with banks in high risk countries.”²⁷ To ensure long-term sustainability and meet client needs, financial institutions in developing nations must not allow themselves to be exploited by money launderers and terrorists.²⁸ Most importantly, while MFIs strive to comply with AML/CFT regulations, they must not sacrifice their primary mission to provide poor people with financial services.²⁹

In 2000, the U.S. Congress passed legislation establishing microfinance as a critical component of U.S. foreign assistance.³⁰ At the time, national security considerations may not have motivated this legislation. But in 2002, speaking about the intersection of poverty and terrorism, President George W. Bush stated, “[p]overty does not make poor people into terrorists. . . . Yet poverty, weak institutions, and corruption can make weak states vulnerable to terrorist networks . . . within their borders.”³¹ Informal and feeble financial systems are vulnerable to terrorist exploitation.

Combating terrorist financing may be best accomplished by bringing the world’s poorest people into the formal financial sector via microfinance. Some argue that helping the world’s poor will alleviate the problem of terrorism because poverty breeds animosity towards wealthier nations. These advocates urge large, western nations to invest fewer resources in national security and more in helping the poor. But both investments are necessary. AML/CFT regulations should be applied to microfinance without compromising on the core principles of increased transparency and customer identification. These rules, which exist to make advanced financial systems safer and more stable, will also enhance the quality of services delivered to the poor. Encouraging the expansion of the microfinance industry without compromising AML/CFT regulations should be a top national security and humanitarian priority of the United States.

II. MICROFINANCE IN LATIN AMERICA

Microfinance is a significant element of the Latin American macroeconomic picture. Market coverage of the microfinance industry in Latin America varies from country to country between 56 percent and

27. *Id.*

28. *Id.*

29. AML/CFT IMPLICATIONS, *supra* note 2, at 9.

30. Coleman, *supra* note 22, at 184 (citing The Microenterprise for Self-Reliance and International Anti-Corruption Act of 2000, H.R. 1143, 106th Cong. (2000)).

31. PRESIDENT GEORGE W. BUSH, THE NATIONAL SECURITY STRATEGY OF THE UNITED STATES OF AMERICA (Sept. 2002), *available at* <http://www.whitehouse.gov/nsc/nss.pdf>.

less than 1 percent.³² Moreover, while much of the market in South America involves MFIs of indigenous origin, a unique feature of the Central American microfinance market is that MFIs affiliated with mainly U.S.-based networks, including ACCION, FINCA, and Opportunity International,³³ tend to enjoy the largest coverage.³⁴

A. LEGAL FORMS OF MICROFINANCE ENTITIES

Organizational structures of Latin American microfinance entities may be divided into two broad categories: unregulated and regulated institutions. Within the category of regulated institutions further subdivisions exist: transformed NGOs, specially licensed microfinance companies, and commercial banks. Each of these organizational forms may be identified by unique characteristics.

1. *Unregulated Institutions*

Latin American microfinance began in the 1980s with religious and socially-motivated NGOs.³⁵ In the beginning, MFI growth “was funded largely by grants and soft loans from donors and governments in the region.”³⁶ These traditional, unregulated NGOs confronted very few barriers to entry into the microfinance market. But due to their unregulated nature, the scope of activities and services offered were typically limited to microcredit products. Currently, unregulated NGOs are the most common form of MFI in the Latin American region.³⁷

2. *Regulated Institutions—Transformed NGOs and Specially Licensed Companies*

Transformed NGOs and specially licensed microfinance companies operate as regulated entities. Traditionally, MFIs were organized as NGOs and received most funding “from multilateral development agencies and, to a smaller extent, private charities and host governments.”³⁸ The first NGO to convert into a regulated MFI in Latin America was a Bolivian NGO, Prodem, which converted in 1992 into a regulated commercial

32. BEATRIZ MARULANDA & MARIA OTERO, THE PROFILE OF MICROFINANCE IN LATIN AMERICA IN 10 YEARS: VISION & CHARACTERISTICS 14 (2005), available at http://www.accion.org/file_download.asp?f=23 [hereinafter PROFILE OF MICROFINANCE]. This report indicates the corresponding market coverage rates: Bolivia–55.7 percent, Peru–26.2 percent, Colombia–13.6 percent, Mexico–6.8 percent, Guatemala–6.0 percent, Honduras–3.9 percent, Venezuela–0.8 percent. *Id.*

33. Opportunity International is a microfinance organization “[m]otivated by Jesus Christ’s call to serve the poor” and dedicated to “[g]iving the poor a working chance.” Opportunity International, <http://www.opportunity.org> (last visited May 15, 2006).

34. CGAP CASE STUDY, *supra* note 11, at 2.

35. ALVARO RAMIREZ, THE MICROFINANCE EXPERIENCE IN LATIN AMERICA AND THE CARIBBEAN 2 (2004), available at <http://www.adbi.org/files/2004.10.04.cpp.microfinance.latinamerica.caribbean.pdf>.

36. *Id.*

37. PROFILE OF MICROFINANCE, *supra* note 32, at 5.

38. IMF MICROFINANCE, *supra* note 13, at 3.

bank, BancoSol.³⁹ Since then, other MFIs in Latin America, which were originally formed as NGOs, have “transformed or ‘upscaled’,” into MFIs regulated by their country’s banking authorities.⁴⁰ On a regional level:

Latin America is clearly leading the way in transforming microfinance from a subsistence activity to a profitable business. In no other region of the world are there as many financially sustainable microfinance institutions

. . . Not only are many Latin American microfinance institutions sustainable, but in several cases they are also very profitable.⁴¹

In recent years, several countries have passed legislation creating new types of specialized financial institutions designed to serve the microfinance sector.⁴² Eleven different types of institutions now exist in Latin America for microfinance purposes.⁴³ Specially licensed companies are distinct from transformed NGOs in that they become licensed “under a special law for microfinance . . . rather than under the general banking law.”⁴⁴ Growing “numbers of MFIs are getting licensed as banks or specialized finance companies,” enabling them to seek financing “by accessing capital markets and mobilizing deposits from large institutional investors as well as poor clients.”⁴⁵

3. *Regulated Institutions—Commercial Banks*

The third group of Latin American MFIs includes commercial banks that, in recent years, have downscaled their operations by reaching out to a poorer clientele.⁴⁶ Some banks create a special microfinance division for conducting interactions with microfinance clients.⁴⁷ Other large, public banks enter the market with a political and social mission.⁴⁸ Commercial bank characteristics, such as well-established internal controls and comprehensive administrative and accounting systems, instill these banks with operational structures that enable favorable performance within the microfinance sector.⁴⁹ Traditional commercial banks, leveraging these structural systems, may successfully compete in the microfinance indus-

39. RAMIREZ, *supra* note 35, at 2.

40. PROFILE OF MICROFINANCE, *supra* note 32, at 5.

41. TOR JANSSON, MICROFINANCE: FROM VILLAGE TO WALL STREET 3 (2001), available at <http://www.iadb.org/sds/doc/MSM113VillagetoWallStreetJANSSON.pdf>.

42. Littlefield & Rosenberg, *supra* note 16, at 40.

43. PRINCIPLES AND PRACTICES, *supra* note 12, at 18. The countries creating these institutions include Bolivia, Brazil, El Salvador, Honduras, Mexico, Panama, Peru, and Venezuela. *Id.*

44. ROBERT PECK CHRISTEN, OCCASIONAL PAPER No.5: COMMERCIALIZATION AND MISSION DRIFT: THE TRANSFORMATION OF MICROFINANCE IN LATIN AMERICA 5 (2001), available at http://www.cgap.org/docs/OccasionalPaper_05.pdf.

45. Littlefield & Rosenberg, *supra* note 16, at 39.

46. RAMIREZ, *supra* note 35, at 2-3.

47. PROFILE OF MICROFINANCE, *supra* note 32, at 5.

48. Notably, “these public banks are the largest suppliers of microcredit in” Brazil and Chile. *Id.*

49. CONSULTATIVE GROUP TO ASSIST THE POOR, FOCUS No.12: COMMERCIAL BANKS IN MICROFINANCE: NEW ACTORS IN THE MICROFINANCE WORLD 2 (1998), available at http://www.cgap.org/docs/FocusNote_12.pdf.

try. For example, Banco do Nordeste, a commercial bank in Brazil, maintains an average outstanding loan balance of US\$253.⁵⁰ In fact, the manager of the Multilateral Investment Fund stated, “[m]icrofinance is the fastest growing, most stable market for Latin American banks. . . . It is a huge untapped market and there is money to be made.”⁵¹

Trends toward regulated MFIs and commercial banks represent the commercialization or maturation of microfinance in Latin America.⁵² Commercialization of microfinance has occurred faster in Latin America than anywhere else in the world.⁵³ Commercial banks now provide 29 percent of microenterprise funds, while transformed NGOs and specialized MFIs provide another 45 percent.⁵⁴ Unregulated NGOs supply approximately 25 percent of all loans to microenterprises in Latin America.⁵⁵ Shifts to more sustainable models of microfinance will continue to occur.

B. MICROFINANCE SERVICES

As a result of the commercialization of microfinance, MFIs are offering a greater spectrum of services and products. MFIs in the form of unregulated NGOs offer predominantly credit products and tend to serve a lower income niche than regulated MFIs. Thus, “the average [loan size] for unregulated NGOs (US\$322) is roughly a third that for regulated [MFIs] (US\$803).”⁵⁶ On the other hand, regulated entities typically offer additional financial services including savings, insurance, and remittances.

Remittance services require special attention. In Latin America alone, 301 million people are affected by poverty, but many of these are being helped by remittances.⁵⁷ MFIs, particularly in the Central America-Mexico region, could seize on a significant business opportunity “to capture and channel these funds.”⁵⁸ Although total worldwide remittance amounts are hard to calculate with accuracy, the most recent estimates suggest global remittances amount to approximately \$140 billion and about \$80 billion of that is sent to developing countries.⁵⁹ The United States is by far the largest source of remittances, while Mexico is the larg-

50. CHRISTEN, *supra* note 44, at 15.

51. Posting of Rob Katz to NextBillion.net—Development Through Enterprise, <http://www.nextbillion.net/newsroom/2005/11/23/banks-to-leverage-remittances-for-microfinance-in-latin-america> (Nov. 23, 2005, 08:13) [hereinafter Katz].

52. See CHRISTEN, *supra* note 44, at 4.

53. *Id.* at 1.

54. *Id.*

55. *Id.* at 7.

56. *Id.* at 13-14.

57. Diego Cevallos, *Latin America: Remittances Rescue Millions from Poverty*, INTER PRESS SERVICE NEWS AGENCY, Nov. 25, 2005, <http://www.ipsnews.net/news.asp?idnews=31189>.

58. CGAP CASE STUDY, *supra* note 11, at 14.

59. DANIEL M. LEIBSOHN, INTERNATIONAL REMITTANCES: CHARACTERISTICS AND COMPARISONS 2 (2004), available at <http://content.knowledgeplex.org/kp2/cache/documents/65853.doc>.

est recipient country.⁶⁰ According to the IDB, \$45.8 billion was remitted by migrant workers to Latin America and the Caribbean in 2004—with Mexico receiving over \$16.6 billion.⁶¹ Over 60 percent of global remittance growth in the past three years may be attributed to these Latin American countries.⁶² Furthermore, IDB President Luis Alberto Moreno, at the 2005 Latin American Federation of Banks Conference, stated that Latin America remittance totals were “expected to surpass US\$55 [billion]” in 2005 with only 10 percent being transferred through the financial system.⁶³ With so many money transfers occurring outside the formal financial system, these remitted funds remain susceptible to terrorist exploitation.

As microfinance services expand to include remittance services, billions of dollars will—to the benefit of poor people—be brought into the stability of the formal financial system. Where these microfinance remittance providers are subject to appropriate AML/CFT regulation, the purposes of these funds will be disclosed. In 2005 alone, if relevant microfinance systems and AML/CFT regulations had been in place, \$50 billion remitted from the United States to Mexico would have safely and securely benefited the poor. Instead, the absence of these funds from the formal financial system leaves open the question whether these U.S.-generated dollars are at risk of being used to finance terror against the very country providing the funds.

Savings services are also increasing rapidly. Data indicates that savings, also known as deposit-taking, by MFIs in nine major microfinance markets⁶⁴ “increased from US\$500 million in 2000 to US\$1.2 billion in 2003.”⁶⁵ Client demand for one-stop shopping is motivating MFIs to provide these savings services.⁶⁶ But another significant impetus to offer savings services is that MFI growth is rapidly exceeding the availability of traditional funding sources, and deposits provide an additional source of funding.⁶⁷

C. FINANCING MICROFINANCE

As the microfinance industry enlarges, MFIs will have four sources of funds to finance future growth: donors, client savings, local debt and equity, and international debt and equity.⁶⁸ Debt financing for microfinance has been used by multilateral and government development

60. *Id.*

61. World Council of Credit Unions, *International Remittance Network*, http://www.woccu.org/prod_serv/irnet/index.php (last visited Feb. 6, 2006).

62. *Id.*

63. Katz, *supra* note 51.

64. “The 9 markets are Bolivia, Colombia, Ecuador, El Salvador, Honduras, Mexico, Nicaragua, Paraguay, and Peru.” RAMIREZ, *supra* note 35, at 10 n.1.

65. *Id.*

66. *Id.*

67. *Id.*

68. JANSSON, *supra* note 41, at 14.

agencies for fifteen years.⁶⁹ Even some local banks have gotten involved as several Latin American MFIs “have tapped local debt markets, largely by issuing private placements taken up by local financial institutions.”⁷⁰

Although equity investments in microfinance have been less common, these investments may now be one of the most popular in the market. Investors range from large banks to single individuals. Deutsche Bank, citing successful experiences with investment in microfinance through local banking partners, set up a consortium in November 2005 to invest US\$75 million in microfinance.⁷¹ Another organization, Kiva, permits individuals to act as global financiers and supply funds directly to microfinance clients over the Internet.⁷² The flourishing field of microfinance is receiving an influx of new forms of financing.

D. REGULATION

Latin American MFIs are commonly regulated under a general banking law rather than under a separate microfinance-specific law.⁷³ Interestingly:

[s]upervision and regulation of microfinance can be a double-edged sword. When properly conceived and implemented, laws and supervisory structures can provide the stability, predictability and support that MFIs need to thrive and that are necessary to protect the savings of the poor. However, inappropriate systems - those that are not adapted to characteristics of microfinance, or those not aligned with the local realities of the microfinance industry - will not foster MFI growth.⁷⁴

As MFI services and legal forms evolve, new questions of regulation arise; policymakers must confront a choice of whether to regulate activities or institutions.⁷⁵

Distinguishing between institutional and functional activity regulation is necessary. Institutional regulation occurs in many countries where MFIs are considered a specific type of entity and are regulated by a sepa-

69. *Id.* at 15-16.

70. Littlefield & Rosenberg, *supra* note 16, at 39.

71. Ximena Escobar de Nogales, *supra* note 19, at 34; Deutsche Bank, *Launch of the Global Commercial Microfinance Consortium*, http://www.deutsche-bank.de/csr/en/pool/Soziales_3247.htm (last visited Nov. 7, 2006).

72. Steve Hargreaves, *Be a Global Financier . . . On a Shoestring*, CNN, Jan. 17, 2006, http://money.cnn.com/2006/01/17/pf/kiva_microfinance/index.htm; Kiva, <http://www.kiva.org>.

73. STEFAN STASCHEN, REGULATORY REQUIREMENTS FOR MICROFINANCE: A COMPARISON OF LEGAL FRAMEWORKS IN 11 COUNTRIES WORLDWIDE 7 (2003), *available at* http://www.microfinancegateway.org/files/3769_03769.pdf.

74. SUPERVISING & REGULATING MICROFINANCE, *supra* note 18, at 10.

75. JANSSON, *supra* note 41, at 9. The report states “[c]urrently, Latin American microfinance NGOs that wish to become regulated entities often times face a very unattractive choice: they can either seek a license as a commercial bank, which involves demanding entry standards . . . , or as a finance company, which may not permit deposit-taking.” *Id.* at 10.

rate microfinance law.⁷⁶ But a functional regulatory approach regards microfinance as a particular financial activity, and MFIs are regulated “according to the economic function they perform, regardless of their institutional structure.”⁷⁷ Understanding these two approaches is helpful when applying AML/CFT regulatory regimes to the microfinance industry. Moreover, understanding the microfinance regulatory environment is simplified by briefly examining the systems of Bolivia, Mexico, and Colombia.

1. *Bolivia*

Bolivia has led the way among Latin American countries for microfinance. This success is the result of a system of specialized microfinance regulation that encourages entities to formalize their operations.⁷⁸ As microfinance was emerging, Bolivian policymakers and regulators established a specific institutional structure for microfinance market participants. The Law on Banks and Financial Entities created *fondos financieros privados*, a specialized type of financial institution for the microfinance market.⁷⁹ Due to these provisions, many Bolivian microfinance providers began operation as regulated entities, and therefore, the entire industry developed as a specialized niche within the financial system.⁸⁰ Although regulation targeted at MFIs may have slowed conventional banks’ entry into the microfinance market, some commercial banks are beginning to enter the market by lending to microfinance NGOs.⁸¹ Bolivia’s favorable regulatory environment enables the country to boast the highest microfinance market penetration of all Latin American nations.⁸²

2. *Mexico*

Historically, Mexico focused little attention on microfinance regulation and lagged behind the rest of Latin America in microfinance growth and performance.⁸³ Yet, in 2001, Mexico initiated regulation of the microfinance sector by establishing a delegated system where federations of MFI representatives act as self-regulators.⁸⁴ Additionally, President Fox’s administration created a Division of Microenterprise within the Ministry of the Economy to encourage the coordination of microfinance initiatives.⁸⁵ But according to several experts, the Mexican microfinance industry would be helped most by regulations, similar to Bolivian regula-

76. STASCHEN, *supra* note 73, at 15.

77. *Id.*

78. SUPERVISING & REGULATING MICROFINANCE, *supra* note 18, at 10.

79. STASCHEN, *supra* note 73, at 7.

80. SUPERVISING & REGULATING MICROFINANCE, *supra* note 18, at 14.

81. *Id.*

82. PROFILE OF MICROFINANCE, *supra* note 32, at 14.

83. SUPERVISING & REGULATING MICROFINANCE, *supra* note 18, at 20.

84. *Id.* at 10.

85. *Id.* at 20.

tions, making it easier for specialized microfinance entities to emerge.⁸⁶ If the Mexican government acts aggressively to create a financial regulatory environment conducive to microfinance, then MFIs in Mexico will expand rapidly.

3. Colombia

Colombian authorities exerted little effort to regulate microfinance until recently.⁸⁷ During 2002, banking regulators established a reporting category for microloans and exhorted commercial banks to extend a significant amount of capital to the microfinance industry.⁸⁸ Yet the Colombian regulatory environment remains vastly different from that of Bolivia. The specialized category of regulated institutions in Colombia has not encouraged NGOs to transform into regulated entities as has occurred in Bolivia.⁸⁹ Moreover, any advantages of transformation were eliminated by the additional costs of becoming regulated.⁹⁰ But in 2003, regulators began addressing some of these drawbacks by allowing specialized microfinance entities to offer savings accounts and borrow from conventional commercial banks.⁹¹ It remains unclear whether these incentives will persuade NGOs to transform into regulated entities.

Perhaps the government's most compelling tool for advancing microfinance is "directed credit."⁹² Under this concept, the government "direct[s] banks to invest in microfinance both as retailers and as wholesalers, through lending to NGOs" and specially regulated MFIs.⁹³ Although government intrusion in the financial system may seem counterintuitive to microfinance and the expansion of capitalistic financial markets, a prod from the Colombian authorities may make all the difference in the growth of microfinance in Colombia.

E. SUMMARY

As a consequence of the increasing commercialization and sophistication of Latin American microfinance operations, the industry is now led by regulated financial entities.⁹⁴ Commercial banks and specialized institutions dominate a sector that was once the exclusive domain of NGOs. These MFIs offer expanded services including savings, insurance, and remittances. New sources of financing are necessary to support this microfinance growth. As entities evolve, services spread, and financing flourishes, appropriate regulations must be implemented. Successful regulatory systems must conform to the unique needs of each nation's

86. *Id.* at 23.

87. *Id.* at 10.

88. *Id.* at 16.

89. *Id.* at 17.

90. *Id.*

91. *Id.*

92. *Id.* at 18.

93. *Id.*

94. JANSSON, *supra* note 41, at 2.

microfinance industry. Understanding these microfinance trends and realities is essential to effectively incorporate AML/CFT regulations with microfinance operations.

III. AML/CFT REGULATIONS

A. OVERVIEW OF REGULATION— PRUDENTIAL VS. NON-PRUDENTIAL

Before examining relevant AML/CFT regulations, it is helpful to understand an aspect of banking and financial system regulation: prudential and non-prudential regulation. Prudential regulation aims “at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions” and “involves the government in overseeing the financial soundness of the regulated institutions.”⁹⁵ Moreover,

[p]rudential regulation is generally much more complex, difficult, and expensive than most types of non-prudential regulation. Prudential regulations (for instance, capital adequacy norms or reserve and liquidity requirements) almost always require a specialized financial authority for their implementation, whereas non-prudential regulation . . . may often be largely self-executed and can often be dealt with by other than the financial authorities.⁹⁶

Microfinance does not jeopardize most, if any, nations’ financial systems on a macroeconomic level. Furthermore, where microfinance entities only offer credit products, no customer deposits are at risk. In such situations, no prudential regulation should be applied because the implications of an entity collapse are marginal in relation to a nation’s overall economic health. Additionally, compliance with prudential regulations may present inordinately difficult challenges to emerging MFIs working to establish sustainable and profitable operations.⁹⁷ As the IMF reports, “[u]nder current circumstances, the costs of bringing MFIs into prudential supervision would probably exceed the associated benefits in the majority of countries.”⁹⁸

Because prudential regulation targets large, sophisticated financial institutions, microfinance entities do not come under the purview of such regulation. But in the case of an increasing number of MFIs where deposit and other services are available, prudential regulation would be prudent.⁹⁹ Yet in many countries, the most important regulatory issues confronting the microfinance industry are non-prudential.¹⁰⁰

95. ROBERT PECK CHRISTEN ET AL., MICROFINANCE CONSENSUS GUIDELINES: GUIDING PRINCIPLES ON REGULATION AND SUPERVISION OF MICROFINANCE 7 (2003), available at http://microfinancegateway.org/files/13473_13473.pdf [hereinafter MICROFINANCE GUIDELINES].

96. *Id.*

97. IMF MICROFINANCE, *supra* note 13, at 13.

98. *Id.*

99. MICROFINANCE GUIDELINES, *supra* note 95, at 8.

100. *Id.*

Non-prudential regulation is more decentralized than prudential regulation. Non-prudential regulation may be imposed by general commercial laws and administered by the government agencies that usually implement those laws.¹⁰¹ But non-prudential regulation usually consists of and “relies on the enforcement of a set of . . . laws, and regulations that are self-executed by” the affected entities or an organization of affiliated entities.¹⁰² Most importantly, non-prudential regulation “tend[s] to be easier to enforce and less costly than prudential regulation.”¹⁰³ Within the microfinance context, non-prudential regulation addresses issues such as fraud prevention and financial crimes.¹⁰⁴

Determining when prudential regulation should apply to microfinance entities is an interesting question but one that will not be examined by this paper. More relevant to this paper is determining whether policies and procedures concerning AML/CFT activities should be imposed by the government and categorized as prudential or treated as non-prudential and self-regulated by microfinance entities. The remainder of Part III examines existing international and domestic AML/CFT regulatory standards.

B. INTERNATIONAL AML/CFT STANDARDS— INTERNATIONAL ORGANIZATIONS

1. *United Nations*

After September 11, 2001, the United Nations Security Council passed Resolution 1373 (UNSCR 1373).¹⁰⁵ UNSCR 1373 laid a foundation for the establishment of an international framework of financial regulation. The resolution succinctly stated its objective to “[p]revent and suppress the financing of terrorist acts.”¹⁰⁶ In addition to its focus on curtailing terrorist exploitation of the financial services industry,¹⁰⁷ UNSCR 1373 exhorts all nations to, “[b]ecome parties as soon as possible to the relevant international conventions and protocols relating to terrorism, including the International Convention for the Suppression of the Financing of

101. *Id.* at 7.

102. IMF MICROFINANCE, *supra* note 13, at 14.

103. MICROFINANCE GUIDELINES, *supra* note 95, at 31.

104. *Id.* at 10.

105. United Nations Counter-Terrorism Committee, *Mandate*, <http://www.un.org/sc/ctc/mandate.shtml> (last visited Oct. 20, 2005).

106. S.C. Res. 1373, para. 1(a), U.N. Doc. S/RES/1373 (Sept. 28, 2001), *available at* <http://www.un.org/Docs/sc/committees/1373/resolutions.html> (follow “S/RES/ 1373 (2001)” hyperlink).

107. *Id.* at para. 1(d) (stating: [All states shall] [p]rohibit their nationals or any persons and entities within their territories from making any funds, financial assets or economic resources or financial or other related services available, directly or indirectly, for the benefit of persons who commit or attempt to commit or facilitate or participate in the commission of terrorist acts, of entities owned or controlled, directly or indirectly, by such persons and of persons and entities acting on behalf of or at the direction of such persons.)

Terrorism of 9 December 1999.”¹⁰⁸

UNSCR 1373 anticipated compliance with the resolution to occur over a three-phase implementation period. Initially, nations will be encouraged to adopt appropriate legislation that should include proactive measures to prevent and suppress terrorist financing.¹⁰⁹ After developing legislation, states should develop and strengthen effective “executive machinery” for the administration and enforcement of legal regimes that suppress terrorist financing.¹¹⁰ Finally, states must enhance “[c]ooperation on bilateral, regional and international levels” as well as cooperation in judicial actions to support the objectives of UNSCR 1373.¹¹¹

Additionally, an inspection procedure has been established to ensure that nations comply with the provisions of UNSCR 1373. In March 2005, the Counter-Terrorism Committee (CTC) issued guidance indicating that on-site inspection teams would have four objectives: (1) analysis of states’ implementation of 1373 obligations, (2) analysis of a states’ capacity to fulfill 1373 obligations, (3) identification of areas where states could use technical assistance in order to comply with 1373, and (4) recommendations to states for more effective implementation of 1373 provisions.¹¹² Inspectors will focus on a member states’: (1) scope of anti-terrorism legislation, (2) existing measures applied against assets used for criminal purposes, (3) effectiveness of law enforcement services, (4) extent of international cooperation, and (5) territorial control.¹¹³ Essentially, the CTC appears to be positioning itself as an international observer of member states’ financial and banking systems.

2. *Bank*

The Bank works singularly and in conjunction with its sister organization, the IMF, to provide technical assistance on regulatory issues. Demand for technical assistance from the Bank has increased as countries “become more aware of AML/CFT requirements.”¹¹⁴ Special effort is being devoted to the development of international best practices regarding two areas: remittance systems and non-profit organizations.¹¹⁵ First,

108. *Id.* at para. 3(d).

109. United Nations Counter-Terrorism Committee, *States’ Reports*, <http://www.un.org/Docs/sc/committees/1373/reports.html> (last visited Oct. 20, 2005).

110. *Id.*

111. *Id.*

112. United Nations Counter-Terrorism Committee, *Framework Document for CTC Visits to States in Order to Enhance the Monitoring of the Implementation of Resolution 1373*, <http://www.un.org/Docs/sc/committees/1373/frameworkdocument.htm> (last visited Oct. 20, 2005).

113. *Id.*

114. INTERNATIONAL MONETARY FUND & WORLD BANK, *ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM: OBSERVATIONS FROM THE WORK PROGRAM AND IMPLICATIONS GOING FORWARD 14* (2005), available at <http://www.imf.org/external/np/pp/eng/2005/083105.pdf> [hereinafter *AML/CFT OBSERVATIONS*].

115. *Id.* at 15.

both the Bank and the IMF have focused significant effort on remittances. The Bank has worked with the Consultative Group to Assist the Poor (CGAP) to examine better ways of integrating remittances into microfinance business models.¹¹⁶ Second, the Bank has worked to understand the AML/CFT risks inherent to NGOs. The Bank wants to protect NGOs from terrorist exploitation without impeding the global flow of charitable contributions.¹¹⁷ Accordingly, the Bank reports, “[w]ork is ongoing with the [CGAP] . . . on appropriate approaches for the application of customer-identification measures by service providers catering to low-income customers.”¹¹⁸ Compliance with customer identification regulations can be a difficult task for many microfinance entities because clientele often do not have adequate identifying records.

Another area of the Bank’s work is developing a risk-based approach to AML/CFT regulatory implementation.¹¹⁹ As the Bank indicates, “[t]he risk-based approach is of great interest to many countries because it allows a targeted assignment of regulatory resources to higher-risk areas.”¹²⁰ The Bank is leveraging its knowledge of risk-profiles in the microfinance industry to design AML/CFT regulatory frameworks that are proportionate to each country.¹²¹ Essentially, the Bank aspires to itemize and prioritize a phased-in implementation of relevant AML/CFT regulations based on individual country conditions.

3. IMF

The IMF adds to the work of the United Nations and the Bank.¹²² While most aspects of microfinance fall under the purview of the Bank, the IMF and the Bank work closely together on a variety of issues.¹²³ Although the IMF has long been involved with efforts to curtail money laundering, the organization intensified its work to combat terrorism financing after the events of September 11, 2001.¹²⁴ Seeking to build on its reputation “[a]s a collaborative institution with near universal member-

116. *Id.*

117. *Id.* at 16.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.* at 19.

122. International Monetary Fund, *The IMF and the Fight Against Money Laundering and the Financing of Terrorism*, Sept. 2005, <http://www.imf.org/external/np/exr/facts/aml.htm> [hereinafter IMF Factsheet].

123. The IMF and the Bank identified “Key AML/CFT Implementation Challenges”:

- Slow progress in implementing effective AML/CFT regimes;
- Insufficient coordination among national agencies;
- Obstacles to international cooperation;
- Underdeveloped tools for financial institutions to identify specific risks . . . ;
- Lack of adequate training at many levels; and
- Difficulties in designing and implementing balanced regulations for remittance service providers and non-profit organizations.

AML/CFT OBSERVATIONS, *supra* note 114, at 20.

124. IMF Factsheet, *supra* note 122.

ship” the IMF has focused on three objectives: (1) conducting assessments of AML/CFT legal and regulatory regimes in accordance with the Financial Action Task Force (FATF) standards, (2) offering technical assistance, in conjunction with the Bank, to help countries strengthen “their legal, regulatory and financial supervisory” systems, and (3) developing policy ideas based on international best practices.¹²⁵

Since March 2004, the IMF has regularly assessed the anti-money laundering regimes of more than fifty countries¹²⁶ using the FATF Forty Recommendations as the standard for its assessments.¹²⁷ The IMF also provides technical assistance to help countries comply with the FATF standards.¹²⁸ In respect to microfinance, the IMF has indicated that “[t]o the extent that microfinance institutions become vulnerable to money laundering and terrorist financing, [technical assistance] programs will be developed to help countries integrate this sector into the AML/CFT regime without unintended consequences on the access to finance by any segment of society.”¹²⁹ The IMF has successfully sought to establish itself as the international supervisor of nations’ AML/CFT regulatory regimes.

4. *FATF*

The FATF, created in 1989, is an intergovernmental body that develops and promotes national and international policies “to combat money laundering and terrorist financing.”¹³⁰ Comprised of thirty-three members including the United States, Mexico, and Canada, FATF “works to generate the necessary political will to bring about national legislative and regulatory reforms in these areas.”¹³¹ The organization works closely with the United Nations, the Bank, the IMF, and FATF-style regional bodies (FSRBs).¹³² The Financial Action Task Force of South America Against Money Laundering (GAFISUD) is a FSRB established in December 2000. GAFISUD includes nine member countries¹³³ from South America who are working “to combat money laundering and terrorist financing as set out in the FATF Forty Recommendations and . . . Special

125. *Id.*

126. IMF SURVEY, *supra* note 5, at 242.

127. IMF Factsheet, *supra* note 122.

128. IMF SURVEY, *supra* note 5, at 242.

129. INTERNATIONAL MONETARY FUND & WORLD BANK, ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM: OBSERVATIONS FROM THE WORK PROGRAM AND IMPLICATIONS GOING FORWARD: SUPPLEMENTARY INFORMATION 30 (2005), available at <http://www.imf.org/external/np/pp/eng/2005/083105s.pdf>.

130. FATF, *What is the FATF?*, http://www.fatf-gafi.org/document/57/0,2340,en_32250379_32235720_34432121_1_1_1_1,00.html (last visited Feb. 10, 2006).

131. *Id.*

132. IMF Factsheet, *supra* note 122.

133. GAFISUD, *About GAFISUD*, <http://www.gafisud.org/home.htm> (last visited Feb. 10, 2006). The nine member countries include: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, and Uruguay. *Id.*

Recommendations.”¹³⁴ FATF published the Forty Recommendations and Special Recommendations on Terrorist Financing to propagate pertinent policy ideas for combating money laundering and terrorist financing.¹³⁵

a. The Forty Recommendations

Currently, more than 150 nations are committed to implementing the Forty Recommendations.¹³⁶ Under the Forty Recommendations, FATF defines financial institutions to include “any institution involved in financial transactions, including financial service providers working with low-income clients.”¹³⁷ But the definition of financial institutions, which would otherwise include microfinance institutions, includes the caveat that “[w]hen a financial activity is carried out by a person or entity on an occasional or very limited basis . . . such that there is little risk of money laundering activity occurring, a country may decide that the application of anti-money laundering measures is not necessary, either fully or partially.”¹³⁸ This language embraces the notion of risk-based supervision and regulation.¹³⁹ In addition to the basic definitions, the Forty Recommendations address other issues such as reporting of suspicious transactions, record-keeping, and customer due diligence.¹⁴⁰

b. Special Recommendations on Terrorist Financing

Although the Forty Recommendations carry substantial weight in forming AML/CFT regulatory regimes, the Special Recommendations on Terrorist Financing address significant areas that are more relevant to the microfinance industry. Three Special Recommendations require specific consideration. First, Special Recommendation VI deals with alternative remittance systems by seeking to ensure that consistent AML/CFT measures are imposed on all forms of value transfer services both informal and formal.¹⁴¹ This recommendation takes on greater significance as MFIs increasingly offer remittance services.

134. FATF, *Financial Action Task Force of South America Against Money Laundering (GAFISUD)*, http://www.fatf-gafi.org/document/35/0,2340,en_32250379_32236869_34355875_1_1_1_1,00.html (last visited Sept. 4, 2006).

135. FATF, *FATF Standards*, http://www.fatf-gafi.org/pages/0,2966,en_32250379_32236920_1_1_1_1,00.html (last visited Feb. 10, 2006).

136. Asmal, *supra* note 1.

137. AML/CFT IMPLICATIONS, *supra* note 2, at 3.

138. FATF, *Forty Recommendations Glossary*, http://www.fatf-gafi.org/glossary/0,2586,en_32250379_32236889_35433764_1_1_1_1,00.html#34289432 (last visited Feb. 10, 2006).

139. AML/CFT OBSERVATIONS, *supra* note 114, at 7.

140. AML/CFT IMPLICATIONS, *supra* note 2, at 4.

141. FATF, *SPECIAL RECOMMENDATIONS ON TERRORIST FINANCING 2* (2004), available at <http://www.fatf-gafi.org/dataoecd/8/17/34849466.pdf>. Special Recommendation VI states that:

[e]ach country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and

Another recommendation, Special Recommendation VII, addresses wire transfer services.¹⁴² MFIs providing remittance services via wire transfers should comply with the recommendation. According to FATF, the objective of Special Recommendation VII is to prevent “terrorists . . . from having unfettered access to wire transfers for moving their funds and for detecting such misuse when it occurs.”¹⁴³ FATF suggests that cross-border wire transfer transactions, which surpass a country’s de minimis threshold,¹⁴⁴ should be accompanied by the originator’s address, or “countries may permit financial institutions to substitute the address with a national identity number, customer identification number, or date and place of birth.”¹⁴⁵

Third, Special Recommendation VIII applies where MFIs organize as NGOs. The recommendation focuses on NGO exposure “to terrorist financing, and requires countries to develop regulation to prevent these organizations from becoming conduits for money laundering or the financing of terrorism.”¹⁴⁶ These FATF Forty Recommendations and the nine Special Recommendations form the foundation of international terrorist financing regulation.

C. DOMESTIC AML/CFT STANDARDS – THE UNITED STATES

The United States has led the way in domestic AML/CFT regulatory development and implementation. After September 11, 2001, the United States adopted the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, also known as the USA PATRIOT ACT (the Act).¹⁴⁷ Title III section 359 of the Act¹⁴⁸ expanded the definition of a financial institution to

subject to all the FATF Recommendations that apply to banks and non-bank financial institutions.

Id.

142. *Id.* at 2. Special Recommendation VII states that:
[c]ountries should take measures to require financial institutions, including money remitters, to include accurate and meaningful originator information (name, address and account number) on funds transfers and related messages that are sent, and the information should remain with the transfer or related message through the payment chain. Countries should take measures to ensure that financial institutions, including money remitters, conduct enhanced scrutiny of and monitor for suspicious activity funds transfers which do not contain complete originator information (name, address and account number).

Id.

143. FATF, REVISED INTERPRETATIVE NOTE TO SPECIAL RECOMMENDATION VII: WIRE TRANSFERS 1 (2005), available at http://www.fatf-gafi.org/dataoecd/34/56/3500_2635.pdf.

144. *Id.* at 2. FATF suggest that if a country adopts a de minimis threshold, then the obligations of tracing, reporting, and disclosure should not apply to transactions below that amount. *Id.*

145. *Id.*

146. AML/CFT IMPLICATIONS, *supra* note 2, at 4.

147. Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001).

148. *Id.* § 359(a) (defining a financial institution as:

cover microfinance institutions. MFIs must comply with regulations affecting transparency and customer identification procedures.

Various financial services, including money services businesses and informal value transfer systems, have been regulated to enhance transparency and disclosure.¹⁴⁹ Regulations require institutions to: register with the Treasury Department's Financial Crimes Enforcement Network,¹⁵⁰ file Suspicious Activity Reports for relevant transactions,¹⁵¹ and satisfy recordkeeping requirements. Registration requirements include providing information on ownership, geographic locations, and operational details.¹⁵²

Customer identification programs are another important aspect of the American regulatory regime. On May 9, 2003, the Treasury Department issued final rules implementing section 326 of the Act. These rules require "certain financial institutions to establish procedures to verify the identity of new accountholders."¹⁵³ Regulated institutions must "obtain and review identifying information for new customers, verify that the information is correct, [and] retain records of the reviews."¹⁵⁴ U.S. regulations regarding customer identification programs surpass the scope of FATF's Forty Recommendations.¹⁵⁵ And although the:

Rules do not apply to a foreign branch of an insured US bank . . . each bank is "encouraged" by Treasury and the federal banking agencies to implement an effective customer identification program throughout its organization, including in its foreign branches, except to the extent that the requirements of the Rules would conflict with local foreign law.¹⁵⁶

a licensed sender of money or any other person who engages as a business in the transmission of funds, including any person who engages as a business in an informal money transfer system or any network of people who engage as a business in facilitating the transfer of money domestically or internationally outside of the conventional financial institutions system).

149. James F. Sloan, *Informal Value Transfer Systems*, 2003 FINCEN ADVISORY, 33, available at <http://www.fincen.gov/advis33.pdf>.

150. Amendment to the Bank Secrecy Act Regulations—Definitions Relating to, and Registration of, Money Services Businesses, 64 Fed. Reg. 45438, 45439 (Aug. 20, 1999) (to be codified at 31 C.F.R. pt. 103), available at <http://www.msb.gov/pdf/msbreg1.pdf>.

151. Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations—Requirement that Money Transmitters and Money Order and Traveler's Check Issuers, Sellers, and Redeemers Report Suspicious Transactions, 65 Fed. Reg. 13683, 13684 (Mar. 14, 2000) (to be codified at 31 C.F.R. pt. 103), available at <http://www.fincen.gov/msbreg.pdf>.

152. Special Rules for Money Services Businesses, 31 C.F.R. § 103.41 (1999).

153. JOHN REVEAL, HOMELAND SEC. CLIENT ALERT: FINAL RULES IMPLEMENTING SECTION 326 OF THE USA PATRIOT ACT FOR BANKS: CUSTOMER IDENTIFICATION PROCEDURES (2003), available at <http://library.findlaw.com/2003/Jun/2/132853.pdf>.

154. *Id.*

155. Customer Identification Programs for Banks, Savings Associations, Credit Unions and Certain Non-Federally Regulated Banks, 68 Fed. Reg. 25090 (May 9, 2003), available at <http://www.fincen.gov/326bankfinal.pdf>.

156. REVEAL, *supra* note 153, at 2.

The United States has led the way in developing a comprehensive domestic regulatory regime. Rules promoting transparency and customer identification programs strengthen MFIs and benefit clientele. But the United States needs to ensure that its legal and regulatory developments are coordinated with advancing international standards. In an era of globalization, the success of American regulation depends on the success of other nations' regulations.

IV. PROPOSED ALTERNATIVES

The expansion of microfinance coupled with the implementation of AML/CFT regulations will increase peace and decrease poverty. Refusal to implement any AML/CFT regulation in a post-9/11 world must be out of the question. But determining how to apply AML/CFT regimes to microfinance is a challenging issue. Two primary approaches have emerged: risk-based implementation and comprehensive implementation.

A. RISK-BASED AML/CFT REGULATORY IMPLEMENTATION

Since the microfinance industry is growing at different rates in various countries, some policymakers contend that taking a one-size-fits-all approach to AML/CFT regulation would irresponsibly inhibit the positive effects of microfinance.¹⁵⁷ These proponents claim that a cookie-cutter strategy would fail to take into consideration differing national laws, numerous MFI organizational structures, and the variety of services offered.¹⁵⁸ Supporters of a risk-based implementation of AML/CFT regulations claim:

[t]he need for a set of regulations tailored to each different type of institution engaged in microfinance can be justified by the fact that their different organizational, operational and ownership structures create risks and weaknesses that are unique to each type of financial entity. The application of a differentiated regulatory framework, however, is complicated by the variety of financial institutions engaged in microfinance activities.¹⁵⁹

CGAP, the preeminent advisory institution for the microfinance industry, supports "(1) gradual implementation of new measures; (2) the adoption of a risk-based approach to regulation; and (3) the use of exemptions for low-risk categories of transactions."¹⁶⁰ CGAP proposes that the implementation of AML/CFT regulations should occur within the context of a risk-based assessment because "the risk of money laundering or financing of terrorism varies with the country context, the institution's legal

157. *PRINCIPLES AND PRACTICES*, *supra* note 12, at 50.

158. *Id.* (stating that "[i]n view of the considerable diversity of financial institutions engaged in microfinance, supervisory authorities cannot apply a standard approach to all of them. The different types of institutions differ significantly in terms of their ownership, organizational structure, operations and overall risk profiles.").

159. *Id.*

160. *AML/CFT IMPLICATIONS*, *supra* note 2, at 1.

form, and the type of financial service.”¹⁶¹

Using a risk-based implementation approach makes sense for several reasons. First, the typical microfinance client profile may reduce the risk of MFIs being used for money laundering purposes.¹⁶² Second, microfinance transactions—whether credit, savings, or remittances—are relatively small.¹⁶³ Small transaction amounts may lessen the risk that MFIs will be exploited by terrorists by not attracting big money.

Despite these factors in favor of risk-based implementation, several reasons discourage such an approach. First, even small dollar transactions are of increasing concern.¹⁶⁴ In fact, FATF experts agree “that the funding needed to mount a terrorist attack does not always call for large sums of money, and the associated transactions are usually not complex.”¹⁶⁵ Second, specific services expose MFIs to greater risk of terrorist abuse. Remittances and money transfer services are more susceptible to money laundering and terrorism financing.¹⁶⁶ Risk-based AML/CFT regulatory implementation is an option worthy of consideration. But inconsistent and differing regulatory regimes across borders will fragment the global microfinance industry and inhibit the inclusion of billions of poor people in the international financial system.

B. COMPREHENSIVE AML/CFT REGULATORY IMPLEMENTATION

Each country and microfinance market possesses unique characteristics requiring a particular set of regulations. But “[a]ppropriate standards are not the same thing as low standards.”¹⁶⁷ If the purpose and goal of microfinance is to improve the lives of poor people by providing financial services, which the developed world currently possesses, then MFIs should think carefully before rejecting stringent AML/CFT regulations suitable for most developed countries. Adopting diluted or phased-in AML/CFT regulations will isolate MFIs and slow the industry’s commercialization. If AML/CFT regulation is going to be effective it must be implemented broadly and consistently across the globe. Thwarting the subversive exploitation of financial systems requires an internationally comprehensive approach.

Opponents argue that comprehensive FATF-standard AML/CFT regulation would restrict and inhibit the emerging microfinance industry.¹⁶⁸ These critics suggest AML/CFT regulation is most likely to have two negative effects on microfinance.¹⁶⁹ First, the cost of regulatory compliance

161. *Id.*

162. *Id.* at 6.

163. *Id.*

164. *Id.*

165. FATF, GUIDANCE FOR FINANCIAL INSTITUTIONS IN DETECTING TERRORIST FINANCING 6 (2002), available at <http://www.fatf-gafi.org/dataoecd/39/21/34033955.pdf>.

166. AML/CFT IMPLICATIONS, *supra* note 2, at 6.

167. PRINCIPLES AND PRACTICES, *supra* note 12, at 101.

168. Porteous, *supra* note 24.

169. *Id.*

may jeopardize the viability of some MFIs.¹⁷⁰ Due to the structure of the microfinance industry, many MFIs are vulnerable to even the slightest increase in operational costs. Increased costs may slow upscaling microfinance entities or deter commercial banks from downscaling into microfinance. Second, in developing countries where microfinance clients may not have physical addresses, national identity numbers, or other identifying information, customer identification programs may be difficult to implement.¹⁷¹ Subsequently, individuals will be precluded from obtaining essential financial services.

Regulators, policymakers, and microfinance practitioners must strive for a balance between over-regulating the industry and excluding present or potential customers versus under-regulating the industry and possibly leaving entire financial systems vulnerable to illicit exploitation.¹⁷² Uneven application of AML/CFT regulation between formal financial systems and emerging microfinance systems will leave both systems vulnerable to destabilization. MFIs should be required to operate within similar constraints as the rest of the international financial system. As MFIs integrate AML/CFT regulations, several factors may be of assistance including: advancing technology, reallocation of donor funds, public-private partnerships, and cross-border microfinance networks.

1. Advancing Technology

Innovative technological advancements may be a solution to this difficult intersection of microfinance and AML/CFT regulation. Automated systems could assist in monitoring for suspicious transactions, while simple personal computing tools could enable easier implementation of sophisticated customer identification procedures. Several countries in Latin America are already using "smart cards, fingerprint readers, and personal digital assistants" to enhance their operational efficiency and expand into more remote geographic areas.¹⁷³ Other "companies in southern Africa are developing low-cost, cell phone-based banking services."¹⁷⁴ MFIs should leverage the power of technology and the Internet to serve the poor while complying with AML/CFT regulations.

2. Reallocating Donor Funds

As fewer international donor dollars are required for MFI operational activity, these funds could be shifted to support and implement AML/CFT regulations. Inevitably, the benefits of AML/CFT compliance include a more stable and secure financial system. Therefore, international groups such as the United Nations, the IMF, the Bank, and USAID should eagerly seek to divert funds and technical assistance to assist the

170. *Id.*

171. *Id.*

172. *Id.*

173. Littlefield & Rosenberg, *supra* note 16, at 40.

174. *Id.*

microfinance AML/CFT compliance effort. Actually, the U.N. has begun to do this via its UNCDF Microfinance MicroStart program that “directs capital to countries with young or emerging microfinance sectors.”¹⁷⁵ For example, Guatemala has received United Nations dollars that allowed one microfinance entity to implement “digital fingerprinting technology allowing illiterate clients to use a thumbprint for access to credit and savings.”¹⁷⁶ Reallocating donor funds will enable MFIs to acquire essential technology, which will enhance AML/CFT compliance.

3. *Public-Private Partnerships*

Partnerships between commercial banks, NGOs, and intergovernmental organizations may be another solution. MFIs, previously organized as NGOs, already possess the relationships and systems for identifying customers and serving the unique needs of microfinance clients. These NGOs and commercial banks could team up to leverage complementary knowledge bases. Such operations are already occurring as demonstrated by the partnership between FINCA, a large MFI, and VISA. FINCA permits VISA to serve a broader clientele by simplifying VISA’s task of processing client applications and meeting applicable AML/CFT regulations.¹⁷⁷

4. *Cross-Border Microfinance Networks*

Microfinance networks with operations in multiple countries must comply with numerous AML/CFT regulatory regimes. To overcome this difficult dilemma, these entities need practical steps for making sense out of the complicated schemes of AML/CFT regulations. MFIs would be well-advised to aspire to the highest AML/CFT standard commonly accepted by the international community. Turning to the IMF for insight would also be wise. Modeling microfinance operations on a system that would be compliant with all of the FATF provisions would be best. As CGAP states, “Even where there is no national AML/CFT regime or where national supervision capacity is weak, institutions should take the initiative to establish measures based on internationally-accepted practices to protect themselves from being used for money laundering and the financing of terrorism.”¹⁷⁸

Aspiring to higher standards than legally required may result in increased operational costs. But for many MFIs, creating a streamlined set of cross-border processes will lower costs. Developing nations with rudi-

175. United Nations Capital Development Fund, *UNCDF Microfinance*, <http://64.233.167.104/search?q=cache:vtuqD3R6veoJ:www.uncdf.org/english/microfinancev/MF+EnglishWeb.pdf+&hl=en&gl=us&ct=clnk&cd=1> (last visited Feb. 6, 2006).

176. *Id.*

177. U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT, *THE GLOBAL DEVELOPMENT ALLIANCE: PUBLIC-PRIVATE ALLIANCES FOR TRANSFORMATIONAL DEVELOPMENT* 128 (2006), available at http://www.usaid.gov/our_work/global_partnerships/gda/pdf/GDA_Report_Jan2006_Part2c.pdf.

178. AML/CFT IMPLICATIONS, *supra* note 2, at 9-10.

mentary or nonexistent AML/CFT regimes would welcome MFIs within their borders that implement higher standards. The IMF could serve as an accrediting intermediary between MFIs and nations by affirming that an entity's policies and procedures were in compliance with FATF standards.

V. CONCLUSION

Terrorist financing and money laundering are a \$1 trillion problem, but even small, illicit amounts may result in big damage. Microfinance is a rapidly growing industry that offers 3 billion of the world's poorest people an opportunity to enter the formal financial system. Microfinance clients now have access to credit, savings, insurance, and remittance services from a variety of providers including NGOs, specialized MFIs, and commercial banks. Due to the increasing commercialization of microfinance, numerous MFIs have become regulated institutions.

Several international organizations, including the United Nations, the IMF, the Bank, and the FATF, are leading the way in applying AML/CFT regulations to the microfinance industry. But policymakers and MFI operators face a difficult challenge in determining the best approach for microfinance AML/CFT regulation. Risk-based implementation poses too great a risk to the stability of the international financial system. On the other hand, comprehensive implementation will ensure that microfinance clients receive the quality of financial services that they deserve.

As AML/CFT regulations expand outward across the globe, microfinance service providers will need to comply with these regulations. Most importantly, while MFIs strive to comply with AML/CFT regulations, they must not sacrifice their primary mission to provide poor people with financial services. Implementing comprehensive regulations will enhance the quality of microfinance services delivered to the poor. Encouraging microfinance expansion without compromising on comprehensive AML/CFT regulatory implementation will protect the peace while profiting the poor.